

## Synopsis of Public Clarification on VAT treatment of compensation-type payments from FTA:

Sr.No	Particulars	Applicability	
1.	A Contractual payment to compensate for loss:	A) Liquidated damages	Out of scope for vat
		B) Cancellation charges or other penal charges	Applicable for vat.
2.	A payment to settle a dispute:	A) To enforce contract terms	Applicable for vat.
		B) Damage compensation	Out of scope for vat.
		C) Payment for granting right or intangible property	Applicable for vat.
3.	A fine or penalty:	The purpose of fines and penalties is to punish the wrongdoer.	Out of scope for vat.
4.	A Payments for Damaged Goods:	A) payment is for breaching pre-existing terms of a contract	Out of scope for vat.
		B) no pre-existing terms of a contract	Applicable for vat.

# Our Evaluation of compensation-type payments under VAT:



Recently Federal Tax Authority (FTA) issued Public clarification guideline on compensation type payments. For VAT to be applicable on such payments it should form part of **consideration**<sup>1</sup> in respect to a supply.

VAT is a tax on supplies of goods and services and accordingly where a payment is not consideration for supply, no VAT is due on the payment. FTA clarification provided for situations where compensation payments may or may not give rise to a **“supply”**<sup>2</sup> for taxable purposes:

## *A contractual payment to compensate for loss:*

- Compensatory payments in the form of “Liquidated damages” are outside the scope of VAT
- Liquidated damages are predetermined compensation amounts that parties to an agreement designate during the formation of the agreement
- The purpose of such payments is to compensate the injured party against loss of earnings and therefore do not form part of consideration in respect to a supply of good or service
- Contracts offering cancellation charges or other penal charges which are of similar nature will qualify for Vat. Such charges are falling under **“cessation, or surrender of a right”**<sup>3</sup> which is covered under definition of supply of services and accordingly will be considered a taxable supply

<sup>1</sup> *“Consideration: All that is received or expected to be received for the supply of Goods or Services, whether in money or other acceptable forms of payment.”*

<sup>2</sup> *“Supply of goods or services for a consideration by a person conducting business in the State, and does not include exempt supply”.*

<sup>3</sup> *“Under Article 3 of Cabinet Decision no. 52 for VAT: cessation or surrender of a right constitutes as supply of services.”*

### *A payment to settle a dispute:*

Dispute settled (in or out of court) and payment is awarded to the injured party, such payment has to be evaluated as below:

- Where the payment is to enforce a contractual term, the payment is consideration for the contractual supply and payment will be consideration for the **supply of the goods**<sup>4</sup> and therefore subject to VAT.
- Where a payment is in the nature of damages or compensation for any loss suffered by a party, such payment can be a payment for loss of earnings or a payment of interest for a late payment and will be outside the scope of VAT.
- If the payment in return for granting a right then it may be subject to VAT. Such charges are falling under **“granting of a right”**<sup>5</sup> which is covered under definition of supply of services and accordingly will be considered a taxable supply.

<sup>4</sup> Under Article 2 of Cabinet Decision no. 52 for VAT supply of goods is : A transfer of ownership of Goods via verbal or written agreement for sale or for a consideration in a compulsory manner. (A transfer of the right to use any assets shall not be treated as a supply of Goods unless the other Person is able to dispose of them as owner.)

*The transfer of Goods between two parties entering into contract causing the transfer of Goods at a later time shall be considered a supply of Goods where the agreement mentions a transfer or intention to transfer the ownership of Goods or a future transfer of ownership of Goods.*

*Supply of water, real estate including sale and tenancy contracts and supply of all forms of energy.*

<sup>5</sup> “Under Article 3 of Cabinet Decision no. 52 for VAT: granting of a right constitutes as supply of services.”

### *A fine or penalty:*

A fine or penalty charge which is imposed for:

- Contravening terms of an agreement,
- Breach of a contract resulting into damage
- performing an unlawful act or
- Imposed by government bodies for breaches of statutory obligations.

Such fines and penalties are not consideration for any supply and therefore outside the scope of VAT.

### *Payment for damaged goods:*

- Payment to compensate for the damage or loss of goods belonging to another person's unlikely to be consideration for a supply and therefore would be outside the scope of VAT provided such payment is for breaching pre-existing terms of a contract.
- In events where there is no pre-existing terms of a contract and the person is obliged to take title of the damaged goods, the payment is consideration for supply of goods and subject to VAT.

## Analysis:

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Whether or not a payment is consideration for any supply, it is necessary to consider the contractual and legal arrangements in full to determine the reason for the payment and the points to be considered for the same is as below:

- Is the payment a consideration for any previously agreed goods or services?
- Is the payment a consideration for a new supply of goods or services?
- Is the purpose of the payment to adjust a previously agreed supply?
- Is there a right being granted in return for payment?
- Is there a promise not to exercise a right in return for payment?
- Is there a right being given up in return for payment?

We appreciate and thank you for going through the information furnished above and welcome you to connect with us for further details.

This article has been written in general terms and we recommend that you obtain professional advice before acting or refraining from acting on any of the contents of this publication.

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